PERAC Financial Bulletin

NO. 19 | OCTOBER 2003

%optimi$m

Marking an emphatic conclusion to the three-year bear market, the US stock market enjoyed another quarter of positive returns as investors exhibited optimism over an improving economy, very low interest rates, and better corporate earnings. However, with job creation remaining weak and equity valuations still high, there were valid reasons to be cautious about the market's future prospects.

PERAC Financial Bulletin

NO. 19, OCTOBER 2003

Commonwealth of Massachusetts
Public Employee Retirement Administration Commission

Printed by PERAC on recycled paper.

5 Middlesex Avenue
Third Floor
Somerville, MA
02145

ph 617 666 4446
fax 617 628 4002
tty 617 591 8917
web www.mass.gov/perac

FINANCIAL MARKET REVIEW

Third Quarter, 2003

A weak finish to September prevented US equity prices from extending their streak of six consecutive monthly gains, but the stock market did manage to have its second straight quarter of positive returns. Barring a fourth quarter collapse, the market appeared likely to avoid the ignominy of enduring the first four-year downturn since 1929-32.

Responding to the stimulative effects of tax cuts and the lowest interest rates in over forty years, the economy appeared to be building upon the healthy growth of greater than 3% reported for the second quarter. Housing sales have continued strong and consumer spending remains steady, but other signs point to a recovery that is still not robust by historical standards. Industrial production is stagnant, durable goods orders remain weak, and business investment continues to be restrained by overcapacity. Indications of high debt burdens and low savings rates also are a concern. Perhaps most ominously and important, jobs creation remains very weak.

Thanks largely to improved productivity, corporate profits have been increasing, but they are not yet back to levels indicative of a truly prosperous economy. While stock prices rose during the past two quarters, most of this increase has been based on forecasts rather than the reality of even higher earnings. As declines in consumer confidence and other indicators in late September began to raise concerns about the durability of the recovery and whether projected earnings would be achieved, stock prices declined sharply during the final week of September.

Among the broad indices, the large cap S&P 500 Index was up 2.2% for the quarter and has risen 13.2% for the year and more than 25% from its lows of last October. (An accompanying chart shows

The economy appeared to be building upon the healthy growth of greater than 3% reported for the second quarter. Other signs point to a recovery that is still not robust by historical standards.

the long-term performance of the S&P 500.) The performance of the technology-laden NASDAQ Composite index led many to question whether the

Chart 1 | The S&P 500: 2003, Year-to-Date

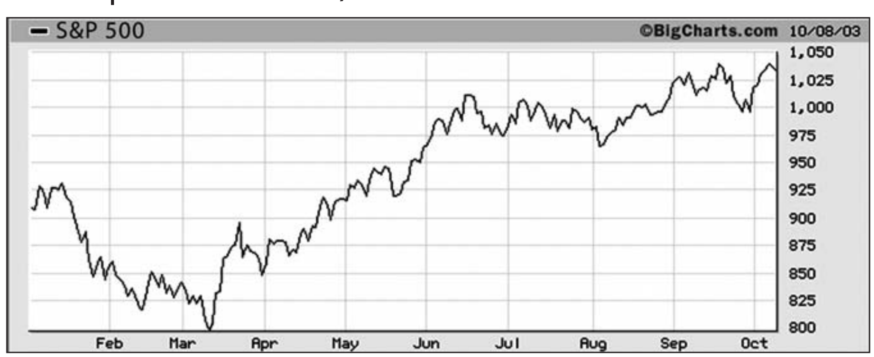

Chart reprinted with the permission of www.bigcharts.com.

lessons from the recent bubble were sufficiently learned as, in the absence of any meaningful improvement in company profitability, the Index rose 2.4% for the quarter, 33.8% for the year, and 60% from last October's low.

Among capitalization categories, small caps—which historically do well at the onset of an economic recovery—have been the place to be this year as the Russell 2000, up 8.8% for the quarter and 27.3% year-to-date, has trounced its large cap counterpart. Mid-cap indices also outperformed the S&P 500. Among styles, growth continued its recovery versus value after three years of lagging results and, after a solid third quarter, is about even with value for the year in all capitalization categories.

As always, performance varied widely among sectors and individual stocks. Among the 30 Dow Jones Industrials, the winners were led by Intel, leading the renaissance by tech stocks as it rose 32% for the quarter and 77% year-to-date, while the laggard was Eastman Kodak, whose slowness to respond to the revolution in digital photography has caused its stock to drop 23% during the quarter and 40% year-to-date.

A major reason why prices pulled back at the end of September was the realization that equity valuations remain high by historical standards even after the major bear market of the previous three years. (See accompanying chart) The S&P 500's price/earnings ratio of 28 relative to past year's earnings and 18 relative to forecasted profits leaves little room for error and seemingly little potential for any higher valuations. The NASDAQ's valuation relative to projected earnings is estimated to be close to 40.

Foreign stock markets have generally followed the lead of the US this year. Aided by a weak dollar, the MSCI-EAFE Index returned 8.1% for the quarter and 18.4% year-to-date. Showing the important impact of currency translation in international returns, the corresponding EAFE returns were only 5.4% and 10.1%, respectively, in local currency

Chart 2 | The S&P 500: 5-Year Perspective

Chart reprinted with the permission of www.bigcharts.com.

Chart 3 | The S&P 500: A Long-Term Perspective

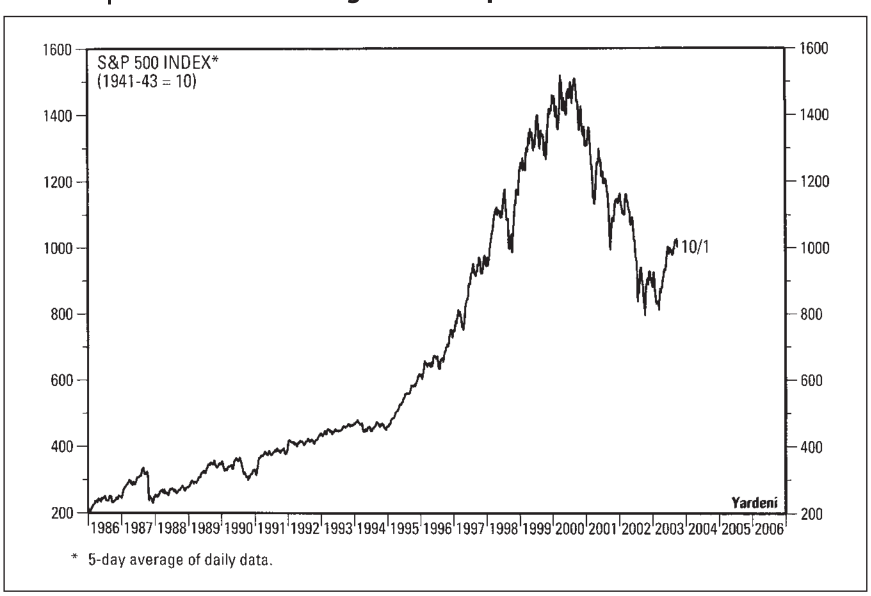

Chart reprinted with the permission of www.yardeni.com.

terms. Japan's market did particularly well, as did other Asian markets, reflecting indications of healthy economic growth while European markets continued to lag.

The fixed income market saw a quarter of above-average volatility and flat to modestly positive returns. Reacting to the indications of economic recovery that led to the stock market's better tone, the yield on the 10-year US Treasury note rose from 3.5% to 4.6%, a 14-month high, before falling back to 3.9% as prospects of economic strength seemed to wane at quarter's end. Reflecting the generally more upbeat economic scenario, corporate bonds have performed better this year than governments or mortgages as yield spreads continue to narrow. (See accompanying chart). As expected during periods of economic optimism and equity market strength, high yield ("junk") bonds have done particularly well. With a differential of about 250 basis points between 2-year and 10-year Treasuries, the yield curve is historically steep.

Although actual returns are not yet available, investors in private equity began to see the light at the end of a very long and dark tunnel. As expected, the sharp rebound in the NASDAQ has translated into a somewhat improved

A major reason why prices pulled back at the end of September was the realization that equity valuations remain high by historical standards even after the major bear market of the previous three years.

Chart 4 | S&P 500 vs. Russell 2000: Small Caps Rule

Chart reprinted with the permission of www.bigcharts.com.

Chart 5 | Equity Valuations Remain High

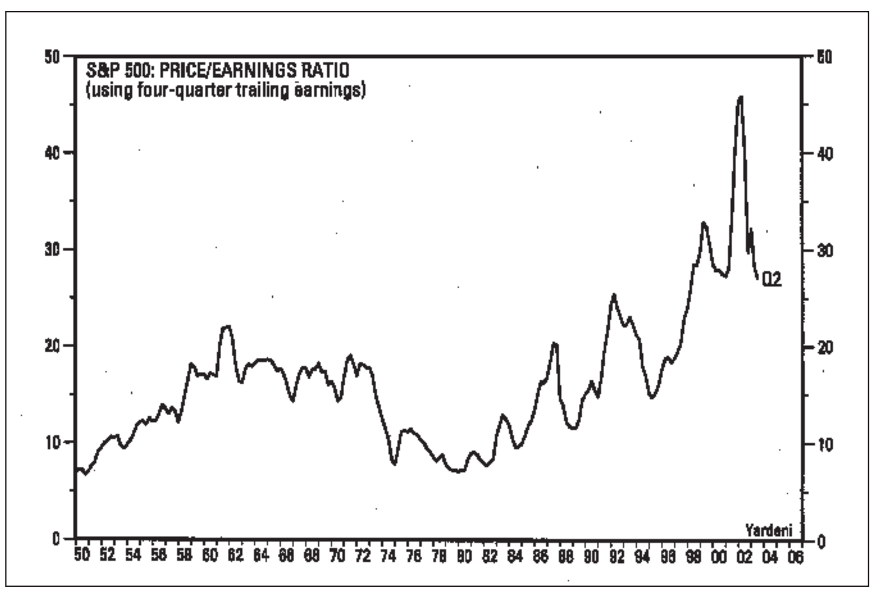

Chart reprinted with the permission of www.yardeni.com.

Chart 6 | Interest Rates Remain Historically Low

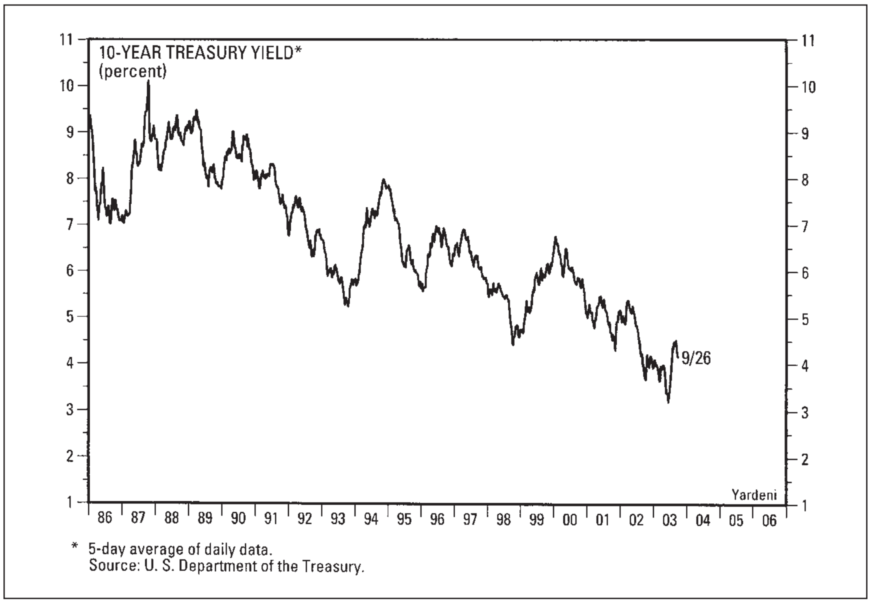

Chart reprinted with the permission of www.yardeni.com.

Chart 7 | Quality Yield Spreads Have Narrowed

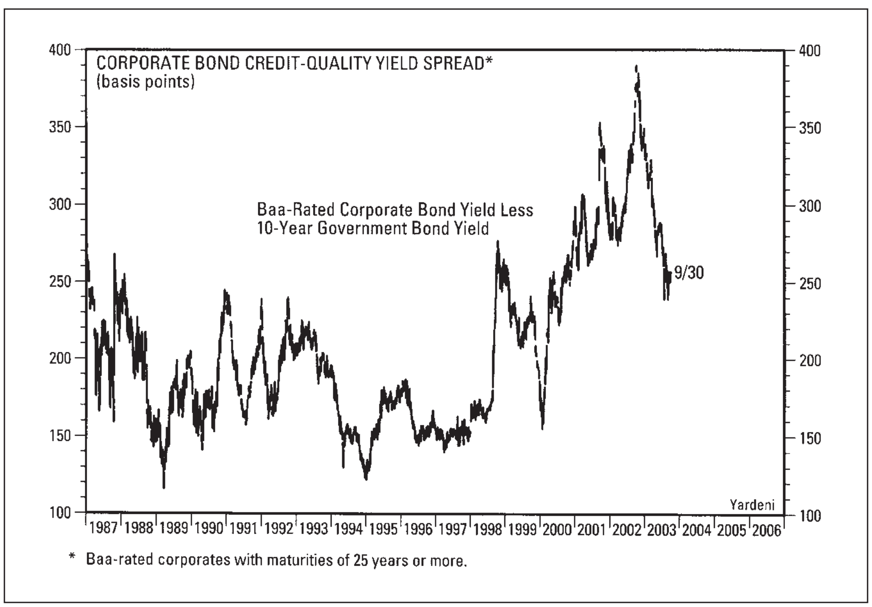

Chart reprinted with the permission of www.yardeni.com.

It is unreasonable to expect a return of the unsustainable high returns of the late 1990s.

market for Initial Public Offerings. Venture capital managers expect to see funding activity rise back to pre-bubble levels.

Real estate has continued to perform well despite concerns about the robustness of the economic recovery. Returns on privately held real estate have been in the 7-8% range. Among the four major sectors (apartments, industrial, office, and retail), retail appeared to be performing best and the office sector worst. Special factors appeared to be behind the surprisingly good performance of publicly traded REITs, which have reported returns of 9.5% for the quarter and 24.7% year-to-date.

Hedge funds are not a true asset class but a collection of different strategies aimed at delivering absolute returns. There is no all-inclusive index or universe of hedge funds, but the most widely-followed indices have reported composite returns (over a wide range of different strategies) in the range of 7-10% year-to-date. There were indications that the SEC, after a year-long study, would likely require most hedge funds to be registered in order to increase the agency's ability to conduct reasonable oversight. Periodic disclosures of fraud or questionable investment practices have involved less than 1% of the approximately 6000 hedge funds in existence, but the recent disclosures that a small number of hedge funds were involved in illegal trading of mutual fund shares illustrates once again that the due diligence required to select and monitor hedge funds is much more difficult than that involving traditional investments.

After three years of negative performance, the typical pension fund should have returns in the vicinity of 10% through the first three quarters of 2003. Actual returns will, of course, vary according to specific asset allocation and individual investment manager performance. Nevertheless, it is unreasonable to expect a return of the unsustainable high returns of the late 1990s. Besides the fact that stock valuations remain historically high, there are already signs that the effects of the post-war euphoria and fiscal/monetary stimulation may be moderating, and the weakness of the US dollar in the currency market may be another cloud on the economic horizon. Thus, retirement boards must remain vigilant in ensuring that their asset allocation is appropriately diversified and in insisting upon adequate answers from underperforming investment managers.

As always, the PERAC Investment Unit welcomes the opportunity to work with retirement boards and to provide assistance in any phase of their investment program.

Chart 8 | The Yield Curve is Very Steep

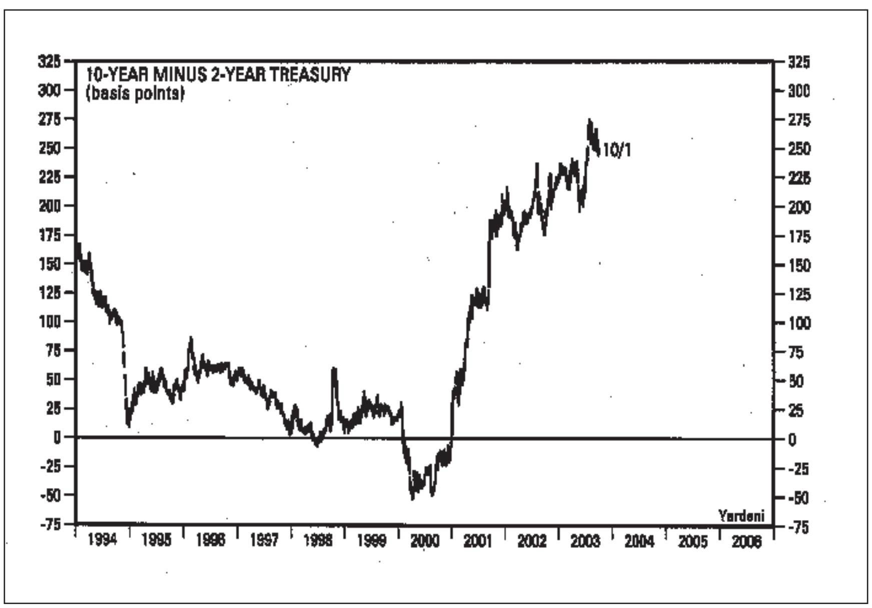

Chart reprinted with the permission of www.yardeni.com.

TOTAL RETURNS | *Third Quarter, 2003*

INDEX	THIRD QUARTER, 2003	YEAR TO DATE
US EQUITY MARKET		
Dow Jones Industrial Avg.	+ 3.77%	+ 13.12%
Standard & Poor's 500 (Large Cap)	+ 2.65%	+ 14.72%
NASDAQ Composite	+ 10.1%	+ 33.80%
Wilshire 5000 (Broad Market)	+ 3.71%	+ 17.10%
Standard & Poor's Mid-Cap 400	+ 6.59%	+ 19.82%
Russell 2000 (Small Cap.)	+ 9.08%	+ 28.58%
GROWTH VS. VALUE		
S&P 500 Growth	+ 2.75%	+ 14.31%
S&P 500 Value	+ 2.54%	+ 15.15%
S&P Midcap 400 Growth	+ 5.99%	+ 19.25%
S&P Midcap 400 Value	+ 7.19%	+ 20.33%
Russell 2000 Growth	+ 10.47%	+ 31.82%
Russell 2000 Value	+ 7.73%	+ 25.49%
INTERNATIONAL EQUITY		
M.S.C.I. - E.A.F.E.	+ 8.13%	+ 18.37%
M.S.C.I. - Emerging Markets	+ 14.15%	+ 32.29%
FIXED INCOME		
Lehman Brothers Aggregate Index	- 0.14%	+ 3.80%
First Boston High Yield Index	+ 3.04%	+ 20.88%
REAL ESTATE		
NAREIT - Equity Real Estate Investment Trusts	+ 9.46%	+ 24.65%
NCREIF Property Index	+ 2.09% (Q2)	+ 7.64% (Trailing)